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NATIONAL FINANCE AND THE INCOME TAX.

THE tariff act of 1894 marks the second occasion on which the government of the United States has undertaken the collection of an income tax.[1] It differs from the first experiment in this direction mainly in this, that it attempts to do, in a time of profound peace and under circumstances of no unusual pressure, what was then boldly carried through as a part of the plan of finance for meeting the strain of a great crisis. That it should attempt to do this by methods not approved by the practice of those countries that have made the most successful trial of this form of taxation is, perhaps, even more remarkable. The first income tax was a product of the Civil War. Although there was then no precedent for the use of this unusual expedient in the history of American finance, its introduction encountered little opposition; indeed, it was one of the earliest of the many changes of system that the war brought with it. It found its ample justification in the extraordinary character of the emergency; and, though hastily developed, crude, and imperfect, it proved itself, during the years when the strain on the national resources was heaviest, a reliance of unfailing strength. There was no thought, however, of retaining it as a permanent part of the

[1] The sections of the Act of August 28, 1894, which make provision for the levy of the income tax, are secs. 27–37.

financial system. It was, indeed, like other parts of the internal revenue system, continued for some years after the war, but it never ceased to be regarded as a part of the machinery of finance made necessary by the war, that was to be put aside on the return of easier conditions. It was repealed in 1870; and it is safe to say that there were few men in public life in this country then, and for many years later, who would have ventured the prediction that, within a period of less than twenty-five years, a Congress would be found, willing to return to the use of this expedient in almost the identical form in which it had first been tried. The unexpected, however, has happened; but it has happened under circumstances that leave little room to doubt that the income tax of 1894 was, at least, as much the result of a legislative caprice as of any well-considered judgment of its necessity. To go no deeper, at this point, into the influences that were responsible for the imposition of this new burden, it is clear that the questions of money and the tariff occupied so much the most prominent place before the Congress that enacted the income tax, that less than ordinary significance attaches to the ready acceptance with which the proposed measure met. A new Congress is as likely to reverse as to continue the policy thus hastily struck, the more so as the methods adopted to give it effect are not such as will tend to commend this form of taxation to the judgment of the people. But, whatever may be the decision of a future Congress, it is hardly to be expected that the enlightened friends of the income tax will permit its fate in American finance to be decided by a single trial, under such unpromising circumstances as the present. The recent legislation on this subject has fairly raised the question, if it has not settled it. For the time being, the income tax marks so radical a departure in the traditional revenue policy of the general government as to raise at once the most serious questions regarding the necessity of change, the nature of the remedy, if any, needed, and the considerations that should govern in the choice.

For upwards of a century, indeed ever since the establishment of the government under the new constitution in 1789, it

has been the well-established policy of the treasury of the United States to place its main dependence for revenue upon indirect taxes levied on consumption; and, among these, the place of first importance has always been held by duties on imports. Little favor has ever been shown by the general government to direct taxation in any form, although Congress was left quite unrestricted in its choice of expedients by the constitution. From the very beginning it turned to indirect taxes as its most appropriate method. The circumstances that determined the choice are easily understood; they were mainly those growing out of the earlier experiences of the colonies and states before union in 1789, and the federal character of the newly created government. And the hold thus obtained, at the outset, by indirect taxes was later considerably strengthened by the additional support derived from the steady presence in our national politics of a party favoring the imposition of high duties on imports for protective purposes. But the main reasons were the two first mentioned. Taxation was extremely unpopular in this country after the beginning of hostilities with the mother-country, and this unpopularity accounts for much that is peculiar in the course of American finance before 1789. It was the general dislike of taxation in almost any form that had led the separate states, in casting about for resources, to adopt that form which universal experience pointed to as the least likely to provoke opposition. Direct taxes were therefore mostly avoided, the needed revenues being raised mainly by taxing consumption in the convenient form of duties on imports. What the states had thus wisely avoided, the federal government was not ambitious to undertake, the less so as it was secured against all possibility of state competition for the main source of revenue, by that provision of the constitution which prohibits the states from laying duties on imports. Without attempting to define the line very sharply, the makers of the constitution had undoubtedly contemplated a division of the sources of taxation between the general government and the states. It was such an idea that suggested the limitation on the taxing power of the states,

just referred to. It was expected that the states would derive the main part of their revenues from direct taxes levied upon the property or revenues of their citizens, and that the general government would most appropriately draw its chief income from indirect taxes on consumption. Some such an apportionment of the sources of revenue was almost a corollary of the federal principle on which the new government was being organized. It was therefore from the beginning instinctively respected by both governments in the exercise of the taxing power. There has been occasional friction, but nothing noteworthy. The original line of cleavage contemplated by the constitution has hitherto been adhered to without difficulty. The income tax of 1894 marks the first noteworthy departure from it, not taken under the pressure of financial necessity. Herein lies its main interest in the history of national taxation. But it has a much deeper significance as an indication of the direction in which the political and social tendencies of the time are working. As regards the former, its chief interest lies in the convincing evidence it gives of the rapidity with which the process of centralization in this country is effectually obliterating the line between state and nation as an important boundary of political functions; and, as regards the latter, it is the most striking assertion we have had, in federal legislation, of the drastic spirit of modern industrial democracy.

The revenue policy of the United States begins with the temporary tariff of July 4, 1789, laying duties on imports and tonnage. The tariff system of taxation was the system, we have seen, which naturally recommended itself at the time; and, although still untried on a large scale, little doubt was felt but that it would prove an adequate basis for the financial system about to be developed. Hamilton, indeed, and others who were largely influenced by his opinions, desired, at the outset, to strengthen the system by the incorporation of certain elements of internal taxation; and, somewhat later, as the growing needs of the treasury caused customs duties to be pushed nearer to what was believed to be the point of highest productiveness, this desire gained

ground, and various internal taxes[1] were then levied to supplement the income from the main source. It was not intended, however, to raise a very large proportion of the public income by internal taxation; and, during the period of their continuance, the internal taxes yielded hardly more than one-tenth of the total tax revenue collected by the government. Trifling, however, as was the amount of revenue that it was attempted to obtain from this source, the new taxes encountered a strong popular prejudice; and dissatisfaction with the internal revenue system of Hamilton was not the least important element of that opposition to federalist principles and practice that caused the political overturn of 1801. Among the immediate changes of system made by the party of Jefferson and Gallatin was the abolition of the internal revenue duties,[2] the step being made possible without detriment to the public revenues because of the unexpected swelling of the receipts from customs owing to the rapid expansion of foreign trade at the beginning of the century. From this time onward down to the Civil War there was no thought of a return to the revenue policy of Hamilton; the decision of 1801 was accepted as marking a definitive change of policy in favor of exclusive dependence on customs duties. The only deviation from the strict line of this policy was that made under the pressure of the trying times of the War of 1812. When all other resources had so far failed that the operations of the treasury were threatened with a complete breakdown, 1813–14, the internal revenue system was brought to its support.[3] But it was of brief duration, disappearing with the special emergency that

[1] The most important were those laid by the Distilled Spirits Tax Act, March 3, 1791, I. *Statutes at Large*, 199; the Carriage Tax Act, June 5, 1794, *Ibid.*, 373; the Stamp Tax Act, July 6, 1797, *Ibid.*, 527; the Direct Tax Act, July 14, 1798, *Ibid.*, 597. The Carriage Tax Act furnished the first occasion for a judicial interpretation of the phrase "direct taxes," as employed in the constitution.—See *Hylton vs. United States*, 3 Dall., 171.

[2] The repealing statute bears date of April 6, 1802, II. *Statutes at Large*, 148.

[3] The acts organizing the system were those of July 22 and 24, 1813, III. *Statutes at Large*, 22, 39. The other important legislation is, the Carriage, License and Auction Tax Acts, July 24, 1813, *Ibid.*, 40, 42, 44; the Stamp Tax Act, August 2, 1813, *Ibid.*, 77, and the Direct Tax Acts, August 2, 1813, January 9, 1815, *Ibid.*, 53, 164.

had occasioned its use.[1] Again, during the Civil War, when the interruption of foreign trade had caused a great falling off in the revenues from imports, and public credit was failing, the treasury turned once more in its embarrassment to internal taxation as its most certain resource; and before the close of the war a system of taxation had been elaborated more diversified, more complex and thoroughgoing in its provisions than any that had ever been developed by the financial necessities of any other country[2] in a similar period of time. But it was devised purely as a temporary expedient, and although parts of the system have lingered on till the present day, this has been simply because the force of circumstances did not permit so speedy an abandonment of the entire system as was possible after the War of 1812. So far as was compatible with the policy of rapid debt reduction, Congress after the war usually availed itself of improving fiscal conditions to diminish the rigor of the internal revenue system. One after another the internal duties were repealed until by 1872 only remnants of the original system were left. And such as were retained have not ceased to be regarded as "war taxes," even to the present day, though continued in times of ease and peace. When Congress took up the question of raising a larger revenue by internal taxation in 1894, there were left of the old system the excises on distilled spirits, beer and tobacco, and the tax on national banks. From these a very substantial proportion of the national revenues is still derived, but their retention is not to be taken as indicating a change in the policy that was deliberately adopted at the beginning of the century; the less so, as the particular forms that have been retained play so fitly into the general scheme of taxing consumption. Our main dependence in times of peace has always been duties on imports; these have been the characteristic part of our revenue system, by

[1] See the Reducing Act, March 5, 1816, III. *Statutes*, 255, which repeals the Direct Tax after the year 1816; and the Internal Revenue Repeal Act, December 23, 1817, *Ibid.*, 401.

[2] See Act for Increased Revenue, August 5, 1861, sections 8–48, XII. *Statutes*, 294; Internal Revenue Act, July 1, 1862, *Ibid.*, 432; Internal Revenue Act, June 30, 1864, XIII. *Ibid.*, 223; Internal Revenue Act, March 3, 1865, *Ibid.*, 469.

reference to which its strength or weakness is to be tested. However lasting the changes which the war may have made in other parts of our financial system, no such sensible impression was produced upon the revenue policy of the government.

Whatever sanction this policy may be thought to derive from its long-continued use by the United States government, it will not be found when brought to the test of examination to possess all those elements which experience shows to be necessary in a well-constructed financial system. Looking at taxation purely in its primary function as a mode of supplying the needs of the treasury, productiveness and expansiveness appear to be the most essential requisites of a well-devised scheme. No tax or system of taxation can be said to satisfy the requirements of fiscal adequacy that is unequal to the task of providing revenues both at the times, and in the amounts, in which they may be needed. The expenditure of government is the measure of its need of revenue, and in the swiftness, ease, certainty and exactness with which this, at any rate to the extent to which it is not to be supplied from other sources, is provided, is found the supreme test of the fiscal expediency of a system of taxes. The ideal contemplated in the ordering of public finances is, or should be, the attainment of as nearly an exact equilibrium between receipts and expenditures as the errors inevitably incident to all matters of financial calculation will permit. Budgetary equilibrium is at once the condition and the symptom of sound finance. Disturbances of equilibrium mean either deficits or surpluses, and both, though in unequal degrees, are evils to be avoided. Whatever misleading implications the doctrine, as ordinarily stated, that in public finance it is expenditure that determines income, may suggest, the substantial element of truth the doctrine contains is yet so far certain that it must be taken as the starting point in any search after the working principles of taxation. Since the supply of the state with adequate resources is the one universally admitted object of taxation, the extent to which any particular system in practice admits of easy adjustment to the varying needs of the treasury may be said to mark the degree of fiscal

perfection attained. As are the expenditures so should be the revenues. Now the leading items in the budget of expenditures of any well-regulated modern state show, under ordinary circumstances, a tolerable degree of constancy from year to year, steady and appreciable growth over longer periods of time, but frequent and sometimes violent fluctuations in times of emergency or disturbance. The tax system should, therefore, combine the different forms of taxation best adapted to secure these different objects. It should not only grow automatically in productiveness to keep pace with the normal growth of public outlay, but it should also contain such elements of elasticity and expansiveness as will make easy the tasks of incessantly adjusting receipts to expenditure, and of providing against the strains of sudden emergencies, without undue inconvenience to the contributors. And an added burden, it is to be observed, is thrown upon the elastic element in a system in which it is necessary to provide, not only for variations of expenditure, but also against fluctuations of receipts.

In both of these respects the revenue system of the United States has shown itself to be singularly defective. Both of the difficulties alluded to have been repeatedly experienced. Leaving out of account the disastrous failures of the customs revenue system during the War of 1812 and the Civil War, and going back no further than the year 1870, striking evidences of the inadequacy of our fiscal system may be found in abundance.[1] The re-establishment of industry on its normal basis after the close of the war and the rapid recovery of credit were followed in 1869 by an unusual burst of speculative activity, affecting almost every branch of trade and industry. Foreign commerce rose with a bound, imports reaching in 1873 the highest point they had ever attained till then and for a decade after. The customs receipts grew correspondingly, and in the years 1870–71 and 1871–72, the treasury was struggling with a surplus of over 100

[1] The reader who desires further information is referred to a detailed historical investigation on "The Adequacy of the Customs Revenue System," by Mr. R. F. Hoxie, in this JOURNAL for December 1894.

millions, for which no adequate outlet could be found, even in purchases of the public debt. In its embarrassment Congress undertook to check the inflow of redundant revenue by a reduction of taxes. The duties on tea and coffee were repealed, the internal taxes on whisky and tobacco were lowered, and the general tariff on imports was subjected to a horizontal reduction of 10 per cent.—all in 1872. But before the effects of these changes were fairly felt the situation of the treasury was quite reversed. The crisis of 1873 caused a great diminution in the volume of imports, and a sharp falling off in the revenues of the government. Customs receipts dropped 25 per cent. in two years, 1872–74, and the movement in this direction continued until 1879, notwithstanding the efforts of Congress to remedy the situation by reimposing, in 1875, the 10 per cent. stricken off of the tariff three years before. In 1878 receipts from customs were more than 40 per cent. lower than they had been five years before, and the treasury was without any effective means of filling up the increasing deficit in its receipts. The shrinkage in the revenues proved so serious that it was necessary in 1875 to suspend purchases on account of the sinking fund. It was not until business revival set in, in 1879, that the situation began to improve, but it then improved so rapidly that by 1881 the treasury was again struggling with a surplus. The wasteful extravagance that was stimulated by the recurrence of this surplus through several succeeding years is a matter of too recent history to need to be detailed here. The result has been that with falling revenues after the depression of 1890 and the panic of 1893, the treasury has been unable during the past two years to meet its engagements, without a resort to borrowing on a considerable scale. The present deficit will probably be short-lived, and it is more than likely that a redundant revenue will appear in the course of a year or two under the tariff of 1894. But then the question must present itself, if not sooner, whether the income tax shall go, or the tariff be lowered and the income tax retained as a permanent part of the fiscal system. Certain it is, that the most urgent

need of our fiscal system is the presence of some elastic element for making possible an adequate provision against the inevitable fluctuations in the receipts from the main source. So long as customs and excise duties continue to be our main reliance, a repetition of the unwholesome experiences of recent years must be expected. Superabundant and highly expansive in seasons of business prosperity, they as readily become deficient under the influence of an unfavorable change of trade, and are a most precarious dependence in the face of an emergency. No kind of revenue is so variable as that derived from taxes falling upon the uncertain and uncontrollable basis of general imports; and none is so hard to regulate without producing disturbances of industry and causing inconvenience to contributors. Excise duties are more stable than customs receipts, but they are plainly not adapted to perform the function of the adjustable element in the financial system. The interests affected by them are too serious to be subjected to the uncertainties of changes springing out of fluctuations of the public revenues. What is needed for this purpose is some tax tapping the fund from which the income of government, however collected, must all ultimately be drawn, more nearly at its source; diminishing, thus, the hardships of sudden changes of rate, while at the same time enabling the treasury quickly to find relief by filling up a deficit or lowering a surplus, as occasion may require. And here it is to be observed that the peculiar qualities, and the remarkable success which has attended the use of the income tax, when applied to the discharge of this function in the financial system of at least one leading European state, make it worth while considering whether a properly arranged income tax may not be advantageously employed in our system. England has now for more than half a century made use of an income tax of variable rate to supply the ordinary deficiencies of receipts from other sources; and the close approximation with which receipts are habitually adjusted to expenditures under the British system is, in no small degree, to be attributed to the action of this unerring financial lever. Going further, and noting the efficacy of the income tax as a

resource for meeting the requirements of extraordinary occasions, it may be said that both English and American experience have proved it to be, under such circumstances, an "engine of gigantic power,"[1] absolutely without a rival. Its productiveness and its expansiveness, and the speed and ease with which the flow of increased revenue can be started in response to an increase of rates—these are the substantial merits which have caused the English income tax to be maintained, in spite of its great unpopularity and the abuses of administration that exist under it. The efficacy, not the equality of the income tax, has been the chief boast of English financiers.

If, then, it had been with some intention of strengthening the weak parts of our financial system that Congress had proposed to undertake the levy of an income tax, the movement in this direction would have much to commend it. But it was from no such point of view that this delicate question was approached. Considerations of fiscal expediency had little or no weight in determining the decision of Congress. The debates disclose surprisingly little reference to the fiscal uses of the income tax. The fiscal necessities of tariff reform were, indeed, urged by some as the real occasion for the introduction of the income tax. But the number of those in whose minds the income tax was coupled as the condition of an effective reduction of the tariff was unimportant. No such necessity as that which brought Robert Peel, fifty years before, in England, to make an income tax the price of commercial reform, existed in the United States in 1894. And, moreover, whatever need there may have been of supplementary taxes to bring up the revenue of the government to the required level, under the changes of duties contemplated in the Wilson bill, quite completely disappeared after the restorations of rates made by the Senate and finally accepted by the House. As enacted, there was every reason to believe that the new tariff of 1894 would soon produce such a copious yield of revenue as to make any new taxation unnecessary. At any rate, it is clear (and

[1] This description was applied by Mr. Gladstone to the English income tax in 1853.—*Financial Statements*, p. 47.

this was pointed out) that any deficiency of revenue that the revision of the tariff might have been thought likely to occasion could be supplied, quite as effectively and at least as speedily, by increasing the internal duties on tobacco, beer, etc., and without producing any such break with existing methods as the introduction of an income tax implied. It would be going too far to deny that the object of the income tax was revenue, but it is just as certain, on the other hand, that the ulterior purpose that controlled the selection of the particular expedient adopted sprang out of an entirely different sort of necessity from that of the treasury. Need of revenue has usually been, in the case of most governments, the occasion for the imposition of new taxes; and, in the choice of methods, the real or supposed interests of the financial system have been allowed chief weight. But neither fiscal necessity nor fiscal expediency counted for much with the Congress that voted the income tax of 1894. The one did not compel the choice nor did the other determine the form of the tax adopted.

The necessity which does, however, explain the easy acquiescence of a majority of Congress in the proposition for the income tax, is the peculiar necessity under which certain classes of politicians habitually find themselves, of accommodating their opinions to the supposed demands of the people, whenever the feeling of popular discontent takes on the form of an organized movement. Party necessity certainly fails to account for it, for neither of the great political parties had ever considered the income tax in convention or embodied any reference to it in its platform; and both were seriously divided on the question of its adoption. At no stage in its legislative history was the income tax a party question; indeed, it hardly became a question in any form until after its passage seemed assured. The tax programme of the Democratic party stopped short with promising a simplification and reduction of the tariff and an equalization of its burdens upon different interests. But, while this was so, the passive attitude that the party took, in 1892, on what was certain to become a question in the next Congress, was not without its significance in

indicating the temper of a considerable section of its following. And, still more, the tide of popular feeling on which the Democratic party was carried into power in the elections of that year, was undoubtedly one that supported the pretensions of those who asserted that the people would expect from the new Congress a much more radical change of system than a mere reform of the tariff. The popular verdict against the McKinley tariff in 1892 reached much further than the tariff. It expressed a general sentiment of hostility against the power of trusts, and monopolies, and corporations, that at bottom springs from the deep feeling of unrest at the widening gulf that separates the wealthy few from the masses of comparatively poor—a feeling which is rapidly becoming a shaping force in American legislation. And it was the momentary strength of this feeling, taking the organized form of Populism, that explains the readiness with which the representatives, of whatever party, from those sections of the country on which the pressure of hard times has weighed with particular severity in recent years, listened to the proposition to impose a tax falling mainly upon the incomes of the rich. Hard times have seldom failed to produce the suggestion of more or less drastic remedies directed against the rich, and taxation is simply one of the convenient methods of social redress that modern democracy has hit upon for this purpose. For some time past, the Populists and other allied political movements, have demanded progressive income taxes as a part of needed reforms, and principally for the reason indicated. To say that in all cases the motives are those of social redress would be an exaggeration. No doubt many of the farmers in the South and West believe themselves to be overburdened with unjust taxes, and are seeking relief. But the chief strength of the income-tax movement came from those who believed that they had a grievance against the rich rather than against the treasury. Nothing else than such a feeling will explain that provision of the new law which places the limit of exemption so high as $4000. And it is precisely this that sets the taint of socialism upon this legislation, and constitutes its main danger. It would be idle to deny the

reasonableness of the popular demand for tax reform, and the wisdom of making substantial concessions to it. The distribution of taxation is far from satisfactory. But it would be just as idle to deny the subversive tendencies of modern radicalism in taxation, and the danger there is of taxation being manipulated as an instrument for depleting the well-to-do and wealthy classes.

There are two broadly distinguishable points of view from which any question in taxation may be approached; completeness of view can only be reached if neither be neglected. The one relates mainly to the interest of the state, the other to that of the individual. Is it expedient? Is it just? These are the questions to which all others eventually reduce themselves. The questions of progressive rates, exemption of the small incomes, heavier taxation of permanent incomes, and the like—these are the questions of justice in taxation. Questions of expediency, on the other hand, relate mainly to the forms, methods, and effects of taxation. Ordinarily, at least, these represent contrasted considerations, because the forms of taxation most expedient for raising revenue are seldom those best adapted for realizing the idea of justice in the distribution of its burden. In its simplest analysis, taxation is taking from the wealth of the individual for the service of the state. To the contributor, therefore, the tax is a sacrifice, to the state it is a gain. So far there is an opposition of interest. The obvious interest of the state is to raise its needed revenue with the least difficulty and, for this purpose, to adopt those methods and objects of taxation which seem best calculated to reduce to the lowest point the inevitable friction between itself and the contributors. The interest of contributors, as a class, on the other hand, is to have the sacrifice for each as far as possible minimized by equitable apportionment of the burden among all. So far there is an agreement of interest between the state and the contributor, for whatever diminishes the sacrifice of taxation for the latter necessarily reduces the difficulty of raising revenue for the former. At this point the views of expediency and justice coincide, and, were this all, the case for justice in taxation would be easily established. But

there is need of a qualification. While it is the interest of the individual as a member of a class to have the apportionment of taxes made equal, as an individual he tries to escape with as small a share of the burden as possible. The instinct of private interest proves stronger than the sense of public duty, and thus destroys the equity the state would observe. Hence the difficulties of taxation. At this point there is a divergence between expediency and justice in taxation. Failing to find in an equitable apportionment the sought-for method of diminishing the difficulty of raising revenue, the state turns to those methods which seek to reduce the burden of taxation by disguising it. Recognizing that sacrifice is quite as much a matter of feeling as of reason, the state chooses for raising its revenue those kinds of taxes which are least likely to suggest to individual experience the fact of their existence or amounts. The modern state feels itself especially strongly impelled to adopt this course, because the rapid growth of its expenditure constantly increases the friction of taxation, and thus embarrasses the raising of revenue. The impatience of taxation is still everywhere such that the state must either abandon the attempt to raise a large revenue or else be prepared to accept the alternative of collecting it by methods inevitably more or less unequal in their operation. It is the *pressure* of modern taxation that complicates the problem of its reform and explains why it is impossible to accept any theory of finance that does not so far subordinate all other considerations as to make expediency the decisive test. The demands of justice are important, but the need of revenue is imperative.

It is, nevertheless, a leading characteristic of the tax-reform movements of the present day to consider questions of taxation mainly or exclusively from the side of justice with little concern for other consequences. The democratic trend is all in this direction. The recent tax reforms of Prussia, Holland and Australasia are so many expressions of this tendency toward the more adequate realization of the ideal of just taxation The attempt is made to throw a larger share of the burden upon

the prosperous classes, by means of graduated rates applied to incomes, inheritances, property and "opportunity"—all these being taken as convenient tests of what a man ought to pay who has been successful. The cost of government under this theory is to be borne in an increasing degree by the few, though it is being incurred in an ever increasing degree for the benefit of the many. The notion of the tax being a payment for benefits has quite disappeared from modern theories of reform, although it held a place of great importance in the financial doctrine of the last century. In the general spirit of the negative doctrine of the time, the eighteenth century individualists laid down the rule that as taxes were the price of the services of government they should be distributed amongst all like any other common expense, in the proportion in which each was benefited by the action of government. The obvious justice of each paying for what he gets was what recommended this simple rule of taxation to the school of social philosophy that invented it, and this same circumstance also explains the strange vitality it has shown, notwithstanding the impracticable nature of the criterion it proposes. Originally invented as a limitation upon the arbitrary exercise of the taxing power by the absolute monarch, it may again be appealed to as the defense of the few against unreasonable taxation by the many. The sound kernel of truth the doctrine contains is the need to which it points of observing some relation between the distribution of the benefits of government and the distribution of the pressure of taxation. That this task is impossible with reference to the individual has frequently been pointed out, for no method of keeping accounts between the individual and the state has ever been devised by which his general liability can be determined on the *quid pro quo* principle. In some few cases, indeed, it has been found possible to measure benefits received, and then they have been made the basis of apportionment, *e. g.*, the water rates, special assessments, etc., of local finance. But while admitting that, in the case of the individual, taxation is something more than a phenomenon of price, it does not follow that the doctrine of proportioning

burdens to benefits may not have some meaning when applied to classes. The class and not the individual, it should be remembered, is becoming more and more clearly defined as the unit in modern taxation. Certain kinds of public action are undertaken by the state specifically in the interest of particular classes, and those who do not participate in the advantages may well complain when they are compelled to contribute for such purposes. The dangers of allowing one class to vote expenditures in its own particular interest, to be defrayed by the taxation of another class, were never so great as under the democratic régime of the present day. And it is against this form of class oppression that the doctrine of taxation in proportion to benefits may well be recalled. Plain justice requires that the burdens should be localized where the benefits are enjoyed. It is only when we are dealing with the apportionment of a given burden among the members of a class, and when we come to those kinds of governmental action that are necessarily so general in their scope as to affect all classes indiscriminately, that there is any occasion to fall back on the ethics of taxation. There is all the more need of caution in this regard because of the illusive character of much that at present parades under the name of the "equities of contribution."

During the past century and more particularly during the past generation, the science of finance has occupied itself as never before in the search after the rules of justice in taxation applicable to the increasingly complex conditions of modern life. Thus far, at least, it cannot be said to have been very successful in the quest, and, mainly, it is to be feared, because of the generally unsettled state of scientific opinion upon the whole question of the nature of the justice to be attained through the social union. The distribution of taxation is more than any problem in distribution "a matter of human institution solely." The ethics of taxation is simply the ethics of distribution applied to a particular set of conditions, and must necessarily wait upon the latter for its satisfactory solution. The wisdom of the century long ago declared that in taxation, as in all other matters of govern-

ment, the principle of equal treatment of all should obtain. But how to realize the idea of equality in a definite working rule of finance is the problem that has not yet been answered. We seem to have made no nearer an approach to a final solution in our day than was reached fifty years ago. The exact content of the doctrine of equality of sacrifice still remains to be determined.[1] There is here a wide margin of debatable ground which each age and each class has always sought to dispose in its own way. The answer that our age is seeking to formulate has been profoundly influenced by the advent of modern industrial democracy to its present position of dominant political influence.

We are fast coming upon the democratic era in taxation; and signs are not wanting that the distribution of taxation in the future will in an increasing degree be affected by the distribution of political power. The phenomenon will not, perhaps, be a new one, for the interests of the ruling classes have always more or less selfishly determined the distribution of taxation; the burden has always displayed a strong tendency to fall along the line of least resistance. The tax system of the Middle Ages, resting upon the feudal doctrine of predetermined class distinctions, favored the exemption of the privileged orders from taxation. Social status, not economic capacity, was the paramount circumstance controlling the apportionment of taxes. Taxes were regarded as a sort of servitude, from which the "honor" of the upper classes relieved them. The decline of the absolute monarchy and feudal aristocracy, and the rise of modern democracy, in the eighteenth century, caused the mediæval rule of class exemption to be followed by the doctrine of universal liability. The new principle of universality was simply the financial counterpart of the political dogma of popular equality. Originally put forth as a protest against privilege, it at first demanded only the taxation of all, but, by a later and logical development, it transformed itself into

[1] It was J. S. Mill who first formulated for English political economy the conclusion that "equality of taxation, as a maxim of politics, means equality of sacrifice." But whether this condition would best be satisfied "by making each contribute the same percentage on his pecuniary means," he confessed himself unable to determine. See MILL, *Principles of Political Economy*, bk. v. ch. ii. secs. 2 and 3.

a demand for the equal taxation of all. An impartial and tenable principle seemed at last to have been evolved. But it is hardly formulated when it threatens to become the instrument of a new oppression, under the democratic dispensation. The "equality" of the rule turns out to be little more than a fiction, which the will of the majority alone can vitalize with meaning. Taxation is still in the hands of a class,—a class that is none the less a class because it arrays the many against the few. And the new justice in taxation which seeks to realize itself under the dispensation of this class is no longer the justice of the individualists, but the "social," "distributive" and "retributive" justice of the socialists. The radical democracy demands a "new norm of equitable taxation, whose function it will be to achieve a systematic alteration of the distribution of income and property."[1] Herein lies the historical significance of the new American income tax. It is the first fruit in federal finance of that peculiar theory of taxation which is based upon a prior theory of the laborer's right.

The earnest mind, anxiously seeking for light between the contending claims of expediency and justice in taxation, may well hesitate before joining the modern crusade of justice. The ways of justice in taxation are, at best, obscure; and we do well to remember when confronted by the perilous nature of present tendencies, that taxation was not designed to be the instrument of justice; and to recall the legitimate objects for which it may be used and the inevitable limitations which must be accepted in any attempt to realize them. These alone will provide the secure footing for estimating the character and extent of needed changes. Expediency must in this, as in all other matters of government, be the final test of fitness. In no department of social inquiry is there so much need of well-tempered conservatism, because in no branch of public action is there so great a temptation to ignorant radicalism, as in taxation. No doubt the purely expediency view may be, and frequently has been, pushed too far in the support of methods that work needless hardship and injustice. The merely expedient that makes no attempt to

[1] GUSTAV COHN, *The Science of Finance*, p. 307 of the English translation.

realize the idea of justice in taxation, taking simply where it most easily can, has almost as little to recommend it as the merely just which can find no forms in which to realize itself. The opportunist maxims[1] that shaped so large a part of earlier tax systems are an inadequate description of the requirements which the modern tax system should strive to satisfy. But even Adam Smith, who placed equality first in the order of the desiderata of taxation, expressly qualified his opinion of its importance when he said that "a very considerable degree of inequality is not near so great an evil as a very small degree of uncertainty."[2] And the finance minister, obliged to face the uninviting prospect of imposing new burdens, has usually felt the force of the precept. To him taxation appears as too real and serious a necessity to be treated in the light of abstract idealism. It is not the financier's business, as England's great war minister expressed it a century ago, to correct inequalities of wealth. If we are to have socialism there are more direct and honest methods than the perversion of taxation. Looking at the great questions of taxation as problems in finance and not in socialism, it may be noted that nothing is gained by ignoring those conditions which have limited the past development of taxation. Like every other process of social life it has been a product of slow growth, one of the chief factors that have hindered its more rapid and perfect growth being the slow development of the individual sense of civic duty. This is the factor which the intemperate radical habitually ignores. Men have seldom paid their taxes honestly or cheerfully; they do not do so now. No civic duty is so reluctantly performed as that of contributing to the support of the state. There is everywhere a limit to the strain which the public conscience can stand, and, what is more, it varies in every individual instance. It is inequality of conscience that makes inevitable inequality of taxation, and justifies the use of

[1] Such as the often-quoted dictum of Colbert, "Comment on peut plumer la poule sans la faire crier;" or McCulloch's characterization of the best tax as "not that which is most nearly proportioned to the means of individuals, but that which is most easily assessed and collected."—McCulloch, *Taxation and Funding*, p. 18.

[2] *Wealth of Nations*, bk. v. ch. ii. part ii.

taxes less equal in themselves than others, because the equality that attaches to the latter in principle cannot be realized in practice. Those rare conditions — Adam Smith noted them with some amazement — which made easy the task of equal taxation in some of the smaller European communities a century ago are still the exception.[1] The reaction of public opinion in favor of indirect taxes as against income and property taxes, in some of the Swiss cantons which have been the trial-field of the democratic theories of taxation during the last half century, is a convincing example of the limits which civic immaturity is bound to set to the realization of theory, whenever theory ignores the conditions of practicability.[2] Our century has witnessed no such solid growth of civic honor as it has of commercial honor. The practical problem in taxation is thus found to be still encumbered with much of its original difficulty. It has even been aggravated: the unprecedented expansion of the expenditures of most modern states has brought them to a position where their need of revenue is far beyond what the community will consciously contribute. And hence the retention of forms of taxation that are productive of revenue if not of justice. Regarded in the light of its original objects and besetting difficulties, it may be said that, while there is little in existing systems of taxation that is altogether satisfactory, there is much that is acceptable, not the least acceptable part being that form of taxation which by its vigorous survival, in spite of aggressive criticism, has proved its fitness and continued necessity under existing conditions.

On its negative side, the present movement in favor of the greater use of the income tax is to be regarded as the outcome of the persistent warfare which has been made on the system of

[1] Writing of the income tax in Hamburg, Smith says: "The tax is generally supposed to be paid with great fidelity. In a small republic, where the people have entire confidence in their magistrate, are convinced of the necessity of the state, and believe that it will be faithfully applied to that purpose, such conscientious and voluntary contributions may sometimes be expected." — *Wealth of Nations*, bk. v. ch. ii. part ii.

[2] See PROFESSOR GUSTAV COHN's instructive article on "Income and Property Taxes in Switzerland," *Political Science Quarterly*, vol. iv. especially pp. 54–64.

indirect taxes by the radical idealism of the century. Popular condemnation has nearly everywhere fallen upon them, they are represented as taxing the needy for the benefit of the well-to-do. Income, it is said, has thus far been neglected in favor of consumption as the measure of taxable liability, and now it is proposed to reverse the process, to meet the demands of social equity. No single argument was more repeatedly urged in support of the income tax in Congress than that derived from the alleged injustice of the opposed form of indirect taxes on consumption. Now, it may be admitted at once, that so far as the prevailing systems of indirect taxation in Europe are concerned the popular prejudice is well founded. In England and Europe generally there can be no doubt that the existing indirect taxes fall with disproportionate weight on the consumption of the poorer classes. But the same cannot be said to be true of the United States. The necessaries of life are not taxed to any appreciable extent in this country, nor is any attempt made to reach the meager incomes of the poor under our systems of state and local taxation. Nowhere are the needy classes dealt with so leniently in the matter of taxation as in the United States. The ordinary wage-earner contributes almost nothing to the support of government except as a consumer of spirituous liquors and tobacco. The main bulk of the customs receipts of the federal treasury is drawn from imports consumed by the upper-middle and well-to-do classes. The masses are not taxed appreciably. And yet we find the sentiment of opposition against taxes on consumption quite as strongly developed among the masses in our own country as in Europe. Here, as there, the leaders of popular thought seem to have found a necessary connection between the form of the indirect tax and the injustice of existing taxation that carries with it an unqualified verdict against consumption as a basis of taxation. This movement against consumption taxes is not altogether modern in its origin, but it has acquired a new importance and a new strength during the last quarter-century, such as make it, for the first time, a formidable force for change. For centuries the

oppressive operation of taxes on consumption has been pointed out, and for at least two centuries back we may trace clearly the literary history of the struggle for their abolition or moderation. The celebrated French school of the Physiocrats, to whose inventiveness, indeed, we owe the very distinction between direct and indirect taxation, boldly rejected indirect taxes almost entirely without reservation, as being at once uneconomical and unjust.[1] And since their time, though there has been much shifting of the grounds of opposition, there has steadily been a strong current of theoretical opinion that has unsparingly condemned taxes on consumption "as the most unjust of all."[2] But the modern movement against the system of indirect taxes has received its chief impetus and support not so much from the economists as from the socialists—and, foremost among these, from Lassalle. Ever since Lassalle sounded the note of attack[3] on the system, the radical democracy has made its abolition a *sine qua non* of fiscal reform. And never, it must be said, have the defects of indirect taxation been stated with such acuteness of insight, such display of learning, such ardor of conviction and brilliancy of rhetoric. In spite of its partisan exaggerations and its inaccuracies, Lassalle's vigorous polemic still remains the most thoroughgoing examination we have of the system of indirect taxation.

[1] MIRABEAU, *Théorie de l'impôt*, p. 222, would have allowed, at least temporarily—until improving economic conditions would make it expedient to depend solely on the impôt unique—taxes on salt and tobacco.

[2] So SELIGMAN, *Political Science Quarterly*, vol. v. p. 59. There has been, it is hardly necessary to note, on the other hand, a no less decisive defense of indirect taxes by those writers who are mainly impressed with the practical difficulties in taxation. The one side has centered its whole attention on the inequality, the other on the necessity, of indirect taxes. The nineteenth century literature of taxation is largely a record of the varying form that this struggle has taken. The seemingly interminable nature of the struggle is a striking example of the almost endless friction between the views of expediency and justice in taxation. With Sismondi's outspoken condemnation: "Le riche échappe à presque tous les impôts sur sa consommation; reduire tous les impôts à celui sur la consommation c'est ramener le système féodal, où le noble et le riche ne payent rien" (*Nouveaux Principes*, vol. ii. p. 485), may be contrasted Thiers's extravagant praise: "l'impôt indirect est celui des peuples les plus avancés dans la civilisation, tandis que l'impôt direct est celui des peuples barbares."

[3] *Die indirecte Steuer und die Lage der arbeitenden Classen*, Zurich, 1863.

Without attempting a formal discussion of the many questions raised by Lassalle's argument, we may come at once to his main thesis that indirect taxes, instead of striking individuals according to their property and income, are paid in much the largest proportion by the poor and necessitous;[1] and so are unjust. This is the ground occupied in common by him and the school of financial theorists that rejects consumption as a basis of taxation. What a man spends, it is said, is no indication of what he earns, much less of what he can afford to pay. The question is thus obviously one that relates to the basis of taxation. Starting from the position that income is the best approximate indication of contributive capacity, it is reasoned that a tax levied on the basis of consumption, however equally imposed, must necessarily result in inequality, simply because there is no constant and uniform relation between the incomes of different individuals and the amounts they devote to consumption. Two men of equal income spend different amounts; if each is taxed at the same rate on his expenditure, he is taxed at a different rate on his income. The fact is undoubtedly as stated, but it does not necessarily follow that the inference drawn from it, namely, that the tax is therefore unjust, is also established. The rigor of the conclusion plainly depends upon the meaning we give to the term income. The doctrine of taxation according to income means little or nothing until its leading term is defined. As frequently employed, income is one of those conveniently vague terms that prevent as often as they assist the formation of sound deductions. "Income alone," says Cohn very properly, "gives no information as to the individual's tax-paying capacity."[2] What we need to know before we can proceed intelligently is what proportion of a man's total income is to be regarded as his taxable income. On this point the work of some writers, it must be confessed, leaves much to be desired. A curious and pertinent

[1] "Der Betrag aller indirecten Steuern, statt die Individuen nach Verhältniss ihres Kapitals und Einkommens zu treffen, [wird] seinem bei weitem grössten Theile nach von den Unbemittelten, von den ärmeren Classen der Nation gezahlt."—*Ibid.*, p. 27.

[2] *The Science of Finance*, p. 379.

example of the source of confusion just alluded to is found in a widely read and much-quoted essay on "The Bases of Taxation," by President Walker.[1] Passing in review, and dismissing in turn, property[2] and consumption[3] as bases of taxation, he issues in favor of revenue, as being the nearest approach to faculty, which he regards as the only theoretically just form of taxation. But does President Walker's reasoning sustain his conclusion? It would seem not. If revenue or income is, in practice, the most equitable basis of taxation, and it is unjust to tax savings, what does the tax on revenue come to but a tax on consumption? There are but two destinations to which wealth in a civilized community will be applied. It may either be saved or spent. If that part which is saved is exempt, what is there left to tax except that which is spent? The logical conclusion of President Walker's argument is: Not income, but income minus savings, *i. e.*, consumption, is the proper basis of taxation. And this conclusion, to which we seem to be conducted by a resetting of the leading terms of President Walker's essay, it is to be noted, is in entire agreement with Mill's conclusion that "no income tax is really just from which savings are not exempted."[4] Both of these economists, starting, the one with "faculty" or "revenue," the other with "means,"[5] as the standard of apportionment, issue, in fact, by a process of elimination, in favor of a definition of revenue or means that would exclude savings and reduce it to partial income or consumption.[6] And this position, it is to be further noted, is in neither case accidental; it

[1] *Political Science Quarterly*, vol. iii. p. 1.

[2] "The fatal fault in a property tax, that which must cause it to be condemned both ethically and economically, is that it constitutes a penalty upon saving."—*Ibid.*, p. 3.

[3] "I see no ground for the assumption that the state has no rights of revenue whatsoever over that portion of the annual product which the individual does not choose to apply to personal expenditure."—*Ibid.*, p. 11.

[4] *Principles of Political Economy*, bk. v. ch. 2, sec. 4.

[5] *Ibid.*, sec. 3.

[6] This is avowedly the position of PFEIFFER (*Staatseinnahmen*, vol. ii. p. 539), who is the foremost theoretical advocate of consumption as the basis of taxation in recent times.

rests upon thoroughly substantial grounds of equity. It is because taxation based on income, unless savings are exempt, taxes that part of income that is saved twice over, "once as earned, and again as saved," that consumption has some claim to be regarded as an equitable basis of apportionment.[1] An example will make this clearer. If we take two men each with an annual income to begin with of $10,000, the one of whom, A, saves one-half his income, the other of whom, B, spends all, is it not clear that, while they would both pay the same sum in taxes the first year, A would pay in addition, during each succeeding year the tax continued, a second tax upon the revenue yielded by his savings, and that the present value of this second tax would be equal by computation, if levied in perpetuity, to the original sum collected by the state on this part of his income? If the rate of interest be taken at 5 per cent. and the rate of the tax at 2 per cent., each would pay $200 in taxes at the first collection. B's contribution would terminate here, but A would pay $5 each succeeding year on the $5000 he had saved. The present value of this sum of $5 annually at the rate of interest assumed would be $100, the exact equivalent of a second tax of 2 per cent. upon the $5000 saved. A's total contribution on his original income would therefore in truth be $300. "To tax the sum invested, and afterward tax also the proceeds of the investment is to tax the same portion of the contributor's means twice over."[2] A definition of taxable income that includes savings appears, therefore, to be inequitable; but one that excludes them leaves it hardly distinguishable from consumption. So far, then, what are *consumption* and *taxable income* but different names

[1] "If revenue, as such, be taxed, a portion of revenue is by a property tax twice excised; once as earned and again as saved. . . . If a man's income belongs to him to spend, it equally belongs to him to save; and, on the ground of equity, the state cannot lay its hands upon that which represents the double virtue of industry and frugality, while sparing that which represents the single virtue of industry."—WALKER, *Bases of Taxation*, pp. 4, 5.

So also ROSCHER, *Finanzwissenschaft*, 315:—"Auf die Sparsamkeit der Privaten übt die Einkommensteuer einen ungünstigen Einfluss, da sie jeden zur Kapitalbildung verwandten Einkommenstheil zwiefach belastet."

[2] MILL, *Principles*, bk. v. ch. 2, sec. 4.

for the same principle? Have not those, therefore, who have hastily taken their stand against indirect taxes on consumption, on the ground that such taxes violate the rule of proportioning taxes to income, need of re-examining their premises? The last word has not yet been said against consumption as a theoretically equitable basis of taxation.

But without pressing the argument in favor of consumption as an answer to those who condemn indirect taxes on the score of their necessary inequalities, and accepting in the full latitude in which it is laid down the doctrine of taxation according to income, the inquiry is still pertinent, whether the method of indirect taxation makes impossible the attainment of that approximate degree of justice which is, after all, the utmost that may be hoped for in any system of taxation. It is to be observed at the outset that this question cannot be settled by an *a priori* deduction. It must in every case be treated as a question the answer to which is to be determined as one of fact. Writers on taxation have long observed that economic conditions, social habits, national peculiarities and the like are of the greatest importance in affecting the concrete problems of taxation. Now if the argument against consumption as the basis of taxation be recalled, it will hardly escape notice that what is there stated as a conclusive fact turns out on closer inspection to be little more than a conditional limitation. Consumption, it is said, fails as a standard of apportionment *because* it bears no constant relation to income. It would be more accurate to say that it fails when, and where, and so far as it does not occupy this fixed relation. It is clear that if everybody spent his whole income a tax on expense would be the same thing with a tax on revenue, it would simply be another way of getting at income. Again, it is clear that if everybody spent substantially the same proportion of his income the tax on expense would amount to an approximately equal tax on income. It would be only when there were great differences between individuals or classes in respect of their habits of spending and saving that consumption would fail to supply an approximate indication of differences of income. Bearing this in mind

let us see whether we can draw from it any important practical inferences applicable to American conditions.

Next to nothing is known about the distribution of incomes amongst different classes in the United States, but enough is known regarding the habits of the most numerous classes of the community in respect of spending and saving to afford ample warrant for the assertion that the average American of the present day spends the largest part of his income in providing either the necessaries or the decencies and enjoyments of life. Nowhere is what a man spends so good an indication of what he earns as in the average American community. The poor, of necessity, here as everywhere, spend all they earn. No one doubts that their consumption equals pretty much the whole of their income. But when we come to the middle classes—those whose incomes provide a wider margin above the normal requirements of a healthful existence—though more allowance must doubtless be made for individual differences of character, we find that savings are reduced to the lowest possible point. The amounts annually placed in the various forms of savings associations and paid on life insurance policies constitute the merest fraction of the total earnings of those classes. One of the most striking facts in the social history of the United States since the Civil War is the decay of the saving habit. The disposition to live, to enjoy, to spend, has quite completely supplanted the desire to save. "In the New England and America of today," writes President Walker, "frugality is not the rule, but the exception."[1] The standard of living has been rising at the expense of saving, with the result that there is today, as compared with the prevailing condition before the war, a wide diffusion of well-being with a very narrow concentration of wealth. "The savings of the nation," writes a leading statistician, "are, apparently, not the savings of the masses of the people."[2] It is only as we approach the higher classes of incomes

[1] "There is not the same interest in saving," President Walker continues, contrasting the present with the condition thirty or forty years ago, "on the part of the majority of producers; there is almost infinitely less of a sense of duty regarding saving; there is, practically, no public sentiment whatever operating to induce or enforce saving."—*Political Science Quarterly*, vol. iii. p. 6.

[2] MR. GEORGE K. HOLMES, *Ibid.*, vol. viii. p. 598.

that we find a considerable margin of difference between the amounts earned and spent; it is only here that consumption fails to supply an approximate indication of income.

Here, then, is a most important condition affecting the problem of taxation in America, both national and local, but more particularly national, which may not safely be neglected in any attempt to ascertain the nature or extent of needed changes. Those circumstances which in the past have made indirect taxes on consumption the main reliance of the national treasury are certain to compel adherence to the same policy, in a large measure, in the future. The superior practicability of indirect taxes for meeting, in the main, the necessities of ordinary occasions has been so abundantly attested by the experiences of modern states, that there can be no serious thought of diminishing dependence on this source. No empirical conclusion of the science of finance is more soundly established than the absolute necessity of indirect taxes in the existing stages of political and social development in which all the western nations find themselves. Indirect taxes are nearly everywhere the most certain support of national finance. And it is entirely clear that if we are to have indirect taxes in American finance, they must continue to be administered under federal authority, whatever their form. There is the less objection to the continued dependence of the United States government upon indirect taxes for the bulk of its income, because of the comparative certainty with which a system of such taxes could be arranged, under American conditions, so as to meet in the main the demands of justice. The condition referred to above, which makes consumption so practically adequate a test of income in the case of the most numerous and important class of the tax-paying population of the country, strips the common theoretical objection against consumption as a basis of taxation of much of its practical force. For this class the assertion is ventured that a well-arranged system of taxes on consumption would mark a nearer approach to a fair income tax than could for a long time to come be hoped to be attained under any direct method of levy. It seems hardly

necessary to add that this is far from being the situation at the present time. Our existing system of indirect taxation is doubtless one of considerable inequality; but that is not because the system is indirect, but because no attempt has been made to secure an apportionment of burdens to the relative capacities of different classes of consumers, within the general limits of the method adopted. The tariff has at no time in the present century been treated purely as a problem in taxation by Congress. We must distinguish between the use and abuse of the principle of indirect taxation. And here it may be remarked that the first and indispensable step in any thoroughgoing reform of federal taxation in the interest of greater justice must be the equalization of the present burdens of the tariff and internal revenue duties on different classes, so far as the resources of the system will permit. Until this is done it is idle to think of substantial improvement. So long as revenue continues to be an incident rather than the main object of the tariff legislation it is little less than folly to talk of equalizing national taxation. When the tariff has been properly reformed in the direction indicated, then, and not till then, will the way have been opened for further changes; then, for the first time, can we ascertain the residue of inequality that remains to be reduced by other taxes.

Recognizing, then, the fiscal necessity of indirect taxes and their compatibility, when carefully adjusted to the consumption of different classes, with the requirements of substantial justice for the bulk of the tax-paying community in the United States, the further problem is to determine what supplementary taxation is needed in order to collect a due proportion from the possessor of the large income and property. It is clear that the wealthy class can never be made to contribute its proper proportion through taxes on consumption alone. Recourse must be had to some form of direct taxation for this purpose. Everything points to its necessity. No system of taxation can be said to satisfy the requirements of modern financial development that does not embrace at least some of the more important elements of direct taxation. And among the various kinds of direct

taxes that have been tried in the present century there is certainly none whose practicability deserves more careful study than the income tax. The functions which a well-adjusted income tax is eminently fitted to perform, both in the financial system and in the tax system, will undoubtedly assign it a more important place in the revenue systems of the future than it has held in the past. In the financial system, as already pointed out, its function is to supply the elastic element; in the tax system its function will be, more and more, that of a complementary tax, falling mainly upon the upper classes as a corrective of the heavier burdening of the masses by indirect taxes. How to combine these two functions in one and the same tax is a work of financial art, but not one beyond the reach of legislative ingenuity. The former requires that the basis of the tax should be broad and the rate movable, the latter that the basis should be narrow and the rate fixed. These purposes are divergent, but not conflicting, and the tax could easily be made to adjust itself to both requirements, resting partly upon a fixed and partly upon a movable base. The remarkable flexibility of the income tax would reduce these difficulties to a minimum. If, for instance, it were thought wise to limit the tax, as one of compensation, to incomes of over $4000, at a rate of 2 per cent., this would not preclude the possibility of levying a second income tax at some other rate on all incomes down to as low a limit as necessity might occasion. At any rate, however the process might adjust itself in practice, these are the features which constitute the main strength of the income tax as a form of taxation, and these are such as will cause increasing attention to be given in the future to the conditions affecting its practicability. Even writers like Leroy-Beaulieu, who feel a strong antipathy toward the use of the income tax for general purposes, concede its usefulness as a tax of compensation;[1] and more than one French minister of finance has been willing, in recent years,

[1] "Cet impôt est essentiellement une taxe complémentaire, une taxe d'appoint et de compensation, qui est destinée à rétablir la justice dans un système fiscal et à demander aux classes aisées et riches un supplément de contribution, parce que ces classes ont été trop ménagées par les impôts indirect."—*Science des Finances* (4. ed.), vol. i. p. 442.

to risk his chances of popularity by proposing the introduction of a tax on incomes after the English model.[1] And these uses probably describe the limits beyond which it would not be expedient to attempt to apply the income tax in the finances of the United States at the present time. None but the impossible theorist, ignoring the practical aspects of taxation, supposes that the time has yet come for making the income tax the chief instrument of ordinary finance.

The theoretical advantages that have been urged for over a century in favor of the general income tax are so well understood that they hardly need to be recalled. They relate principally to the value of income as a test of taxable capacity. The aggregate income of society being the normal fund from which the income of government, however collected, is ultimately derived, the contributive capacity of the individual, it is said, is most accurately indicated by the proportion that his income bears to the total. Property, product, expenditure, which have thus far been chiefly used as bases of apportionment, however useful they may be as subsidiary tests of income, are alone, it is said, inadequate measures of income. The whole development of taxation, the historical school of finance concludes, points to the necessity of applying to income directly through the form of the income tax, if the demands of equity are ever to be satisfied. The income tax alone is equal to the task of fully taking account of the personal factor in production. Against these undoubted advantages of the income tax the empiricist has always set the practical difficulties of its fair administration. Even Mill could not conceal his fear that "the fairness which belongs to the principle of an income tax cannot be made to attach to it in practice." And the reports of the frauds and abuses that are still practiced under the English, Prussian, and even the Swiss income taxes leave little reason to suppose that Mill would have modified his opinion had he written at the present time.[2]

[1] See M. PEYTRAL's proposal, *Journal des Economistes*, November 1888, p. 239.

[2] Vocke, *Die Abgaben*, p. 487, calls the Prussian income tax a "huge lie" ("grosse Lüge").

Whether the United States can reasonably expect to make even the rough approximation to justice that these countries do is at least rendered doubtful by the disheartening results which have attended the assessment of the personal-property tax in every state of the union where it has been tried. It certainly cannot do it under the methods of the present law,[1] and it would hardly be worth attempting it, even according to the best approved methods of modern practice, were it not for the eminent desirability of such a resource as the income tax in the financial arrangements of this country.

How far the income tax of 1894 is calculated to perform either of the functions already described as the legitimate uses of an income tax in the United States; what scope the recent decision of the supreme court, declaring unconstitutional so much of the law as sought to impose the income tax on the income of real property and the bonds of states and localities, leaves for the profitable use of the tax; and what substitute could be found for the income tax in case the whole law should be pronounced invalid, are questions that cannot be entered upon here. The judgment of well-informed opinion has already condemned the leading discrimination of the present tax. The exemption of incomes under $4000 is a species of confiscation that will be endured only because the rate of the tax is light. It creates, instead of correcting, inequality. As regards the second question raised, the situation is not so serious as might at first sight appear. The exemption of the income of public bonds from the operation of the law undoubtedly produces an inequality in the tax that will result, so far as existing issues of these bonds go, to the advantage of the present holders, but which, should the tax be continued, will result, on new issues, in benefit to the states and municipalities, because of the better terms at which they will be able to negotiate their securities. Much less serious is the exemption of real property. Taking, as we should,

[1] For detailed criticisms of the Act of 1894, see PROFESSOR DUNBAR'S article in the *Quarterly Journal of Economics*, October, 1894, and PROFESSOR SELIGMAN'S in the *Political Science Quarterly*, December, 1894.

the pressure of taxation as a whole, both national and state and local, it may be said that real property already contributes much more than its fair proportion; and the income tax, so far as this class of property was concerned, would simply have added to a grievance of which the land-owning classes, particularly in the agricultural sections, justly complain as things are. So that the omission, under the requirements of the constitution, of these two forms of income would not, after all, be so damaging to the equity of the income-tax principle. The loss of revenue would be more serious than the creation of inequality. What future the income tax might have as a state tax, and what substitute might be found for the income tax in federal finance, should the whole of the present law be set aside, are difficult questions. Particular circumstances, in addition to those already pointed out, seem to recommend the income tax to the favor of the general government. The lines which the reform of state and local taxation are likely to follow in an increasing degree in the future are discernible in recent legislation. The abandonment of the general property tax seems certain, and the reorganization of the new system will be on the basis of a segregation of the leading sources of revenue between the different political divisions. In the apportionment, inheritance and corporation taxes are already falling to the states, and real property is likely to be the main and most appropriate support of local finance. The income tax is not adapted to either state or local administration. The same circumstances that have made the state personal-property tax a failure it may be confidently expected would repeat themselves in connection with a personal-income tax. Shut out from these lucrative sources, where, then, could the federal government find a substitute for the income tax?

A. C. MILLER.

UNIVERSITY OF CHICAGO.